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11:39 - JUNI 19TH 2015

China – from investment-led to innovation-led growth

FABRIZIO ZILIBOTTI



«The view that China can preserve its socio-political stability only if it grows at a 10% annual rate is pure phantasy.»

As China's economy becomes more liberalized, the authorities will scrap growth targets altogether and turn to the more modest notion of growth forecasts. A column by Fabrizio Zilibotti.

China is preparing its 13th Five-year economic plan at a particularly delicate juncture of its development process. After a golden decade, economic growth has slowed down since 2012. Forecasts set the GDP growth rate below 7% this year, with no rebound in sight for 2016. These figures are not per se especially alarming. Both developed and developing economies are subject to business cycle fluctuations, and a seven percent growth rate in a downturn is nothing worrisome. In addition, it is both physiological and in line with the predictions of economic theory that as China grows richer its growth speed will decline.

The view that China can preserve its socio-political stability only if it grows at a 10% annual rate is pure phantasy. If all is well, China will grow at an annual

About the author

Fabrizio Zilibotti is Professor of

FEB 16TH 2016 INTERNATIONAL SELECTION



The Three Fears Sinking Global Markets

A lethal combination of self-fulfilling expectations and policy errors could cause economic reality to bend to the dismal mood prevailing in financial markets. A column by Anatole Kaletsky.

FEB 15TH 2016 INTERNATIONAL SELECTION

five-to-six percent over the next decade. This would suffice for the average living standards of its citizens to raise at the level of Poland or Portugal today. In this scenario, the most developed areas of the country would attain Western European living standards by then.

Yet, there are valid concerns that things might not run so smoothly. Since the launch of the Chinese stimulus plan in 2009, economic growth has relied on anomalous high investment rates, even for Chinese standards. Sumptuous projects run by local governments plus overinvestment in construction and resource-related industries have built an extraordinary excess capacity causing a rapid decline in the rate of return to capital. According to recent estimates, total factor productivity growth has halved in the last five years. This growth pattern is not sustainable.

Beware of the middle-income trap

The ghost in Beijing's offices is the so-called middle-income trap. International evidence suggests that many economies find it difficult to continue to grow fast as their GDP reaches 25-to-30% of the technology frontier, defined by the productivity level of countries such as the United States or Switzerland. While there are a few remarkable success stories (e.g., Korea, Taiwan and Singapore), there are also numerous examples of economies whose growth process appears to have «hit the wall». Examples include Brazil, Mexico and Peru, and possibly even Malaysia and Indonesia. With a GDP per capita of 23% of the US level, China may have reached this turning point.

In joint research with Daron Acemoglu and Philippe Aghion, we argue that the crux to escape the middle-income trap is to introduce policy and institutional reforms that trigger a switch from «investment-led» to «innovation-led» growth. In a nutshell, economies that are technologically very far behind can catch up fast by promoting investments and by copying the more productive technologies used by advanced economies. However, growth loses steam as a country's gap from the leading edge technology shrinks.

At that point, countries that do not activate the innovation engine fall into the middle-income trap. China's institutions have been successful in promoting investment-led growth. There are also signs of an increasing innovative capacity among the local firms, including remarkable success stories such as Baidu and Alibaba. However, the transition towards innovation-led growth necessitates economic reforms that raise the opposition of vested interests.

Local authorities between corruption and effectiveness

Consider, for instance, the role of local governments, as laid out in some recent research from the leading Chinese researchers Chong-en Bai, Chang-tai Hsieh and Zheng Song («Crony Capitalism with Chinese Characteristics»). In many developing countries, local governments are pure rent-seeking agencies that deter business activities. They extort money from firms without offering any service in exchange. While corruption is also widespread in China, local governments do not deter business. Rather, they compete to

Macroeconomics and Political
Economy at the University of Zurich.



The Negative Rates Club

Creditor countries' central bankers must stop trying to manipulate their economies with more potentially counterproductive monetary easing. They should allow the recovery to run its course. A column by Daniel Gros.

FEB 12TH 2016 [INTERNATIONAL SELECTION](#)



Don't be afraid of China

China will not plunge in a crisis barring huge mistakes which are always possible. Even if it only grows at 5%, or even 3%, this is still better than in the West. A column by Charles Wyplosz.

FEB 11TH 2016 [INTERNATIONAL SELECTION](#)



The End of the New Normal?

The fear is that policies will fail to pivot away from reliance on central banks, and end up looking back to the new normal, with all of its limitations, as a period of relative calm and wellbeing. A column by Mohamed A. El-Erian.

FEB 11TH 2016 [INTERNATIONAL SELECTION](#)

attract firms by offering them to get around all regulatory hurdles, and by granting them local monopoly power. Level playing field competition is replaced by a network of local bilateral agreements whereby particular firms are granted special privileges.

There is both a virtuous and a vicious part to this practice. On the one hand, local governments and party organizations are effective. Contrary to other developing countries, they are competent, hard-working and powerful, in the sense that they are not challenged by competing formal or informal powers. In this environment, bribing a local government is a safe investment for private firms. On the other hand, shady bilateral deals block the competitive pressure from non-entrenched firms. Local government can easily do that by enforcing the rule «to my friends a favor, to my enemies the law».

These discriminatory practices have been successful in promoting private investments. However, the resulting cronyism is a barrier against innovation-led growth. The latter requires an intense churning, namely, incumbent firms must be replaced by the entrants as soon as these bring about new ideas and better technologies. Moreover, local monopoly power deters the incentive of over-protected incumbent firms to innovate.

Business rules, financial markets, judiciary

Xi Jinping’s anti-corruption campaign is challenging the traditional way of operating of local governments. However, without complementary measures, it may prove insufficient or even counter-productive. The worst-case scenario is one in which local governments simply apply clunky formal regulations to all firms, deterring both investment and innovation. What should China do? It should first of all reform radically the formal rules to make business, by which the World Bank ranks China as one of the worst countries in the world, comparable to Zambia and Guatemala.

Moreover, a number of additional institutional hurdles must be tackled. The first is the underdevelopment of domestic financial markets that makes it hard for worthy start-up projects to be funded. Venture capitalism is still in its infancy. A successful example of what China needs is the lending program to start-up projects and small entrepreneurs promoted by the e-commerce giant Alibaba. This program has reached a volume of credit of two billion dollar, with 312,000 granted loans. Yet, this is still a drop in the ocean. Promoting institutions that finance the development of innovative ideas and new firms remains a major challenge.

Another issue is the lack of an independent judiciary system. If a local government harasses a non-connected firm which poses a challenge to an entrenched partner firm, it is almost impossible for the victim to defend its legitimate interests in court. Judges can be removed by discretionary interventions of the party organization. This is a controversial theme: the central authorities acknowledge the urgency of limiting the discretionary power of local authorities. Yet, a radical reform of the judiciary system that makes judges totally independent from the control of the communist party is not in sight.

target would be counterproductive

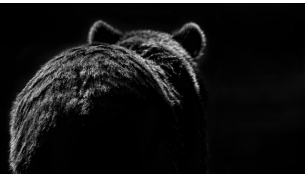
laying out the policy priorities, the plan will provide an explicit growth target. There are divided opinions about what this figure should be. Some local officials have suggested that the target should be ambitious in order to mobilize the



The Angry Quarter

Defenders of open societies must rally support for their ideas, uphold the values of the West, and prevent the preachers of populism from expanding the Angry Quarter. A column by Carl Bildt.

FEB 10TH 2016 [INTERNATIONAL SELECTION](#)



Fred Hickey: «We’re certainly well into a bear market»

Fred Hickey, editor of the widely read investment newsletter «The High-Tech Strategist», warns of more trouble to come for stocks and spots bright investment opportunities in the gold sector.

and local governments. Others argue – correctly in my view – that a high would be counterproductive. If the economic outlook continues to be y ambitious target may induce central and local governments to continue build-up of infrastructure and construction sites. This approach may buy over the next two or three years but at the cost of undermining the r a sustainable market-oriented development. For this reason, any target nual growth rate would be unadvisable.

y, I find the notion of growth targets to be as misleading as misdirected. y becomes more liberalized, the Chinese authorities will sooner or later to scrap such targets altogether, turning to the more modest notion of its.

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